No. 177

JUN 23 1955

HAROLD B. WILLEY, Cl

IN THE

SUPREME COURT OF THE UNITED STATES

October Term 1954

ANN F. AMES, - - - - - - - Petitioner,

versus

THE MENGEL COMPANY, ET AL., - Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SIXTH CIRCUIT.

(AND APPENDIX)

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May, 1955.

WESTERFIELD-BONTE CO., INCORPORATED, LOUISVILLE, KY.

INDEX.

PAGE

Opinions Below 2

Jurisdiction 2

Questions Presented for Review 3

Statement of the Case 4– 8

Reasons for Granting the Writ 8–10

Point I: Rule 23(b) Does Not Require a Stockholder to Follow a Futile Procedure as a Requisite for Instituting Action 11–13

Point II: Section 14:9-1, Et Seq. as Amended and Interpreted Were Unconstitutional 13–16

Point III: Both the Revised Option of 1949 and the Issuance of the Stock in 1949 Constitute a Gift of the Corporate Assets 16–17

Point IV: The Issuance of 10,000 Shares of Stock Violated Section 14:8-9 of the New Jersey Revised Statutes and Was Therefore Illegal 18–19

Conclusion 19

Appendix, Statutes 21

Cause Argued and Submitted 24

Judgment 24

Petition for Rehearing 25

Order Denying Rehearing 25

ALPHABETICAL LIST OF AUTHORITIES.

	PAGE
Bromschwig v. Carthage Marble & White Lime Co., 334 Mo. 319, 66 S. W. 2d 889	17
Backus v. Finklestein, 23 F. 2d 357 (D. C. Minn.)	17
Bank of Commerce v. Goolsby, 129 Ark. 416, 196 S. W. 803	18
Continental Security Company v. Belmont, 206 N. Y. 7, 99 N. E. 138	12
Carruthers v. Jack Waite Mining Co., 14 F. R. D. 475 (S. D. N. Y.)	13
Combes v. Getz, 285 U. S. 434	14
Delaware & Hudson Company v. Albany & Susquehanna Railroad Co., 213 U. S. 435, 29 S. Ct. 540, 53 L. Ed. 862	12–13
Deuts, Presto, Kirche v. Presto of Elizabeth, 89 N. J. Eq. 242, 105 Atl. 642	17
Endicott v. Marvel, 81 N. J. 378, 87 Atl. 232	13
Eliasberg v. Standard Oil Co., 23 N. J. Super 431, 92 A. 2d 862	16
Easton National Bank v. American Brick & Tile Co., 70 N. J. Eq. 732, 64 Atl. 917	18
Faunce v. Boost Co., 15 N. J. Sup. 534, 83 A. 2d 649	14–16
Grupe v. Rudisill, 101 N. J. Eq. 145, 136 Atl. 911	14
Holthusen v. Edward G. Budd Mfg. Co., 52 F. Supp. 125 (D. C. E. D. Penn.)	17–18
Holcombe v. Trenton White City Co., 80 N. J. Eq. 122, 82 Atl. 618	18
In Re: Newark Library Ass'n, 64 N. J. L. 217	14
In Re: Western Tool & Mfg. Co., 142 F. 2d 404 (C. A. 6)	13
In Re: Collins—Doan Co., 1 N. J. Super. 441, 61 A. 2d 913, 915	14–16
Kerbs v. California Eastern Airways, 90 Atl. 2d 652 (Del.)	12–17
King Machine Co. v. Caparoso, 2 N. J. Super. 230	17

PAGE

Marcus v. Otis, 168 F. 2d 649 (C. A. 2)..... 17
Penn v. Robertson, 115 F. 2d 167 (C. A. 4).....12–17
Rogers v. Guaranty Trust Co., 288 U. S. 123, 53 S. Ct. 295, 77 L. Ed. 652.....12–13
Rogers v. Hill, 289 U. S. 582..... 17
Rosenthal v. Burry Biscuit Corp., 30 Del. Ch. 299, 60 A. 2d 106 17
Slutzker v. Rieber, 132 N. J. Eq. 406, 28 A. 2d 525....12–13
Schwab v. E. G. Potter Co., 194 N. Y. 409, 87 N. E. 670 12
Steinberg v. Hardy, 90 F. Supp. 167 (Conn.)..... 13
Steinberg v. Adams, 90 F. Supp. 604..... 13
Sohland v. Baker, 15 Del. Ch. 431, 141 Atl. 277..... 18
Tooker v. National Sugar Co., 80 N. J.Eq. 305, 84 Atl. 10 12–16
Teehan v. United States, 25 F. 2d 884 (D. C. Mass.). 18
Upson v. Otis, 155 F. 2d 606 (C. A. 2)..... 17
Von Arnim v. American Tube Works, 188 Mass. 515, 74 N. E. 680 12
Vanden Bosch v. Michigan Trust Co., 35 F. 2d 643 (C. A. 6). 14

Statutes.

Rule 23(b) Federal Rules of Civil Procedure..... 3, 9
New Jersey Revised Statutes:
14:8-9 . .....3, 4, 12, 18
14:9-4 . . ..3, 8, 11, 14, 19
14:9-1 . . ..5, 13, 17
14:9-2 . . .. 8, 15
14:9-3 . . ..14, 15
14:2-8 15
Article I, Section 10, U. S. Constitution..... 15

Text Books.

Fletcher Cyclopedia of Corporations, Section 764, page 807 12

IN THE

Supreme Court of the United States

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ANN F. AMES, - - - - - - - *Petitioner,*

v.

THE MENGEL COMPANY, ET AL., - *Respondents.*

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SIXTH CIRCUIT.

The petitioner, Ann F. Ames herein prays that a Writ of Certiorari be issued to review the judgment of the United States Court of Appeals for the Sixth Circuit entered February 7, 1955, affirming the judgment of the United States District Court for the Western District of Kentucky, granting summary judgment for the respondents.

OPINIONS BELOW.

The Opinion of the United States Circuit Court of Appeals for the 6th Circuit is reported in 219 F. 2d 704 and is appended hereto in the Appendix, page 24.

The Findings of Fact and Conclusion of Law and the Revised and Supplemental Findings of Fact and Conclusions of Law of the District Court for the Western District of Kentucky are not officially reported but are included in the Record appended hereto, Appendix, page 57a, 74a.

The Opinion of the United States Circuit Court of Appeals for the 2d Circuit, which involved solely a procedural question in that suit, but involving the same litigants, is reported in 219 F. 2d 704.

JURISDICTION.

1. The judgment of the Circuit Court of Appeals sought to be reviewed was entered February 7, 1955.

2. The Order of the United States Circuit Court of Appeals extending time for petitioners to file their Petition for Rehearing until March 10, 1955 was entered February 25, 1955.

3. The Petition for Rehearing was denied March 25, 1955.

The jurisdiction of this court is invoked under 28 U. S. C. 1254.

QUESTIONS PRESENTED FOR REVIEW.

1. Does Rule 23(b) of the Federal Rules of Procedure require a plaintiff to seek stockholder action prior to instituting a stockholder derivative action when such requirement would be futile because:

(a) The acts complained of constitute a gift of the corporate assets of an officer and director of the corporation and could not be ratified without unanimous consent.

(b) The acts complained of illegally permitted the issuance of stock in exchange for a note upon which there was no personal liability or collateral other than the stock in violation of the New Jersey Revised Statute 14:8-9 and could not be ratified without unanimous consent.

(c) The stockholders could not alter or amend the plan as revised by the directors, because the plan had long been consummated by the time the stockholders had any knowledge of the revision.

2. Was the 1948 amendment of Section 14: 9-4 of the revised statutes of New Jersey as interpreted by the Circuit Court of Appeals unconstitutional in that it changed the requirements that a stockholder plan could only be modified, changed, altered or revised with the consent of two-thirds of the stockholders to permit a plan to be materially changed by the Board of Directors unless 51% of the stockholders objected to the revised plan. Thus

(a) Depriving stockholders of the protection of their voting rights.

(b) Depriving stockholders of their right to appraisal on the passage of a stockholder's plan, which was not approved by that stockholder.

3. Whether the Court of Appeals erred in rendering a decision in conflict with other circuits and decisions of this Court and the Courts of New Jersey in permitting the directors of the corporation to make a gift of corporate stock to another director.

4. Whether the Court of Appeals erred in rendering a decision in conflict with the decisions of the Courts in New Jersey and other jurisdictions in violation of Section 14: 8-9 of New Jersey Revised Statutes, which decision permitted the issuance of stock in exchange for a note upon which there was no personal liability and no other consideration of any kind.

STATEMENT OF THE CASE.

The facts of this case are not in dispute. On May 19, 1944, the Board of Directors of the Mengel Company passed a resolution granting to Alvin A. Voit, the President and a Director of the Company, an option to purchase 10,000 shares of the unissued common stock of Mengel Company at any time prior to December 31, 1949 at $10 per share. The option specifically provided that no part of the option might be exercised unless Mr. Voit was in the employ of the company at the time of its exercise. The resolution specifically provided that the option was not remuneration for services but was given as an incentive to the President.

In 1944 Section 14:9-1 *et seq.* required that any option plan had to be formulated by the Board of Directors and thereafter approved by two-thirds of the stockholders at a meeting called for that purpose. That any modification, revision, amendment, alteration or change had to likewise be approved by two-thirds of the stockholders.

In conformity with the statute, a meeting of stockholders was called and the resolution was approved by two-thirds of the stockholders at a meeting held on February 27, 1945, although approximately 36,000 shares of the total vote of 229,000 shares voted against the resolution.

Within a week thereafter, on March 6, 1945, Mengel Company filed with the New York Stock Exchange a Listing Application signed by Mr. Voit and this Application stated that (1) the cash to be received at the rate of $10 per share would be added to the general funds of the company and (2) $1 of the cash received from Mr. Voit was to be credited to capital and the remaining $9 would be credited to capital surplus (R. App. 34a, Exhibit C).

The option as approved by the stockholders in 1945 was never exercised by Mr. Voit. Approximately two months prior to the expiration date in October, 1949, the directors authorized a completely new plan which permitted Mr. Voit to exercise his option and purchase the 10,000 shares of stock by giving the corporation a demand note in the amount of $100,000. with interest thereon at 3% per annum. The resolution provided that Mr. Voit would not be personally liable upon the

note, but that the corporation would look solely to the collateral pledge for the payment of the note. As collateral for the payment of the note the corporation was to hold the 10,000 shares of stock as security, but the directors' resolution provided that all dividends on this stock were to be applied towards the payment of interest and the balance in excess of the interest requiremets was to pay the principal due on the stock. Under the resolution, Mr. Voit also had the privilege of withdrawing so much of the stock pledged as collateral as from time to time payments were made on the note. There was no requirement that Mr. Voit had to remain in the employ of the company in order to exercise the option. Shortly thereafter, Mr. Voit purportedly exercised this new option by giving his demand note upon which he was not personally liable in the sum of $100,000. to Mengel Co. At the time of the exercise of the option Mr. Voit did not have a contract of employment with Mengel & Co. nor did he at any time thereafter have a contract of employment with the company.

For a numbebr of years prior to 1949 the devidends paid on shares of stock were far in excess to the proposed interest requirements on the stock. For the year, 1949 and the years subsequent thereto the dividends on each share of stock varied between 2½ to more than 6 times the interest requirements on the stock.

During the pendency of these actions Mr. Voit acquired approximately 5,000 shares of the stock

through the application of dividend payments on the note.

In the proxy statement, dated April 4, 1950, the stockholders were informed "by action of the Board of Directors approved by the stockholders of the company on February 27, 1945, Mr. Voit was granted an option to purchase 10,000 shares of Common Stock of the company at $10.00 per share. Mr. Voit exercised this option on April 26, 1949. * * * The purchase price of $100,000 for this stock is evidenced by a demand promissory note dated October 26, 1949, executed by Mr. Voit, bearing interest at the rate of 3% per annum from date, payable semiannually. Certificates for the 10,000 shares of Common Stock have been issued in the name of Alvin A. Voit, but are held by the Company as security for the payment of the promissory note, above mentioned, it being provided in said promissory note that the Company shall look solely to the 10,000 shares of stock pledged as collateral for the payment of this note."

There is no disclosure to the stockholders that the option plan as approved by the stockholders in 1945 had been materially changed in October, 1949 by the Board of Directors so that instead of Voit paying $100,000 in cash upon the exercise of his option he was permitted to pay a note in the sum of $100,000.00 upon which he was not to be personally liable and the stock was issued to him.

Initially the District Court decided this case in favor of petitioner, finding that (a) there was a material variance between the original 1945 option

plan approved by the stockholders and the 1949 plan put into effect by the directors' resolution, (b) there was no full disclosure to the stockholders that the directors had materially changed the option granted by the stockholders, (c) the directors in effect authorized a gift of the stock to Mr. Voit of which the stockholders were unadvised (Findings of Fact and Conclusion of Law, filed August 4, 1953, App. 57a). Before summary judgment could be entered for petitioners the respondents called the Court's attention to a 1948 Amendment to New Jersey Statute 14:9-4 which provided that any plan previously adopted could be "amended or revised" by the directors of a corporation and any amendment or revision so made by the directors of a corporation could be changed or repealed by the stockholders (App. 78a). New Jersey Statute 14:9-2 still provides that any "modification" of a plan has to be approved by ⅔ of the stockholders (App. 1a).

Upon the basis of the revised statute 14:9-4 summary judgment for defendants was then entered by the District Court and the United States Court of Appeals for the Sixth Circuit affirmed.

REASONS FOR GRANTING THE WRIT.

This case involves novel and unsettled important questions of constitutional law and corporate law governing the exercise of option plans and the issuance of stock, and the construction of Rule 23(b) of the Rules of Federal Procedure (81a).

It will stand as a landmark of universal application as granting power to a Board of Directors to make a gift of options and of stock, and to permit the issuance of stock in violation of the customary statute requiring that the corporation receive value for its stock.

The decision if it is permitted to stand will necessarily upset all previous conceptions of the intepretation of Rule 23(b) of the Federal Rules of Procedure. Of necessity this interpretation of Rule 23(b) must affect the rights of all stockholders in every publicly held corporation in the United States. It will permit derelict directors to use Rule 23(b) as a shield from prosecution.

There is involved a constitutional question which transcends the importance of the case itself. The decision herein is in conflict with all prior decisions of this Court and the Courts in New Jersey which limit the right of a State to pass legislation (except as a necessary police power) which impairs the property rights of stockholders of a corporation. By its very nature the extension or modification of what has heretofore been the limitation of the powers of a State must affect hundreds of thousands of stockholders not only in the State of New Jersey, but in every State in the Union.

The principle that corporate directors may not make a gift of their assets to another director has universally been the law in this country. It has specifically been the law in the State of New Jersey and has continuously been followed in the Federal Courts. This

decision would became a landmark in corporate law to permit minority stockholders without their approval to be deprived of their property by their directors making a gift to another of their directors. This is contrary to all the decisions involving fiduciary law not only in the State of New Jersey, but in every Court of the country. Of necessity the principal at stake is of paramount importance in corporate law.

In practically every State there is a statute which prevents the issuance of stock in exchange for anything other than property or money. The decision in this case permitting the issuance of the stock to Mr. Voit in exchange for a note upon which no one is personally liable imperils the rights of stockholders and creditors in every publicly owned corporation in this country. The decision must act as a beacon light to corporations in the State of New Jersey and every other State to sanction the issuance of stock to an officer in exchange for a nonenforceable promise to pay. This is contrary to every decision in every Court.

The use of the corporate stock to produce dividends as a means of paying for the self-same stock has been held to be illegal in the cases cited hereafter. Consequently this decision is in conflict with the decisions in the Second Circuit and in every other State.

The decision grants summary judgment, because the petitioners have not as a prerequisite of instituting action secured from the stockholders such action as they desire. There is no decision upon the merits.

POINT I.

Rule 23(b) Does Not Require a Stockholder to Follow a Futile Procedure as a Requisite for Instituting Action.

In October, 1949, the directors' resolution permitted Mr. Voit to exercise his option by giving his demand note upon which he was not liable. When Mr. Voit exercised his option in October, 1949, the plan was consummated. Even under the Revised 14:9-4, N.J.R.S., there was in 1950 no plan in existence which the stockholders could alter or revise. Therefore, any request made to them would have been futile.

At the time of the stockholders' meeting in 1950, it was not revealed to the stockholders that the consummated plan was not in accordance with the plan passed at the stockholders' meeting in 1945, but was a revised plan adopted only by the directors. The stockholders never knew they had the right to alter or change the plan, because they did not know that it was a director's plan.

The 1949 revised plan of the directors constituted an option which created a gift to Mr. Voit, because Mengel received no consideration for the option. The issuance of the stock in exchange for a note upon which Mr. Voit was not liable was a gift of the assets of the corporation.

If the issuance was not a gift then the use of the stock to create dividends to pay for itself was the use of corporate assets for the benefit of Mr. Voit and was illegal (law, *post,* p. 17).

The issuance of the stock in exchange for the note upon Mr. Voit was not liable was illegal, because it violated Section 14:8-9 New Jersey Revised Statutes (law, *post*, p. 18).

If the exercise of the option constituted a gift or was illegal it could not be ratified by the stockholders, except unanimously. This is the law of New Jersey and the law as enunciated by this Court and every other jurisdiction.

Slutzker v. Rieber, 132 N. J. Eq. 406, 28 A. 2d 525;

Tooker v. National Sugar Co., 80 N. J. Eq. 305; 84 Atl. 10;

Fletcher Cyclopedia of Corporations, Section 764, page 807;

Von Arnim v. American Tube Works, 188 Mass. 515, 74 N. E. 680;

Schwab v. E. G. Potter Co., 194 N. Y. 409, 87 N. E. 670;

Penn v. Robertson, 115 F. 2d 167 (C. A. 4);

Rogers v. Guaranty Trust Company, 288 U. S. 123, 53 S. Ct. 295, 77 L. Ed. 652;

Continental Security Company v. Belmont, 206 N. Y. 7, 99 N. E. 138;

Delaware & Hudson Company v. Albany & Susquehanna Railroad Co., 213 U. S. 435, 29 S. Ct. 540, 53 L. Ed. 862;

Kerbs v. California Eastern Airways, 90 Atl. 2d 652 (Del.).

Under the New Jersey law a stockholder need not seek action by other stockholders if the action of the directors cannot be ratified.

Endicott v. Marvel, 81 N. J. 378, 87 Atl. 232;
Slutzker v. Rieber, 132 N. J. 406, 28 A 2d 525.

The Federal Courts have uniformly held that it is not necessary to secure stockholders approval when such a demand would be futile.

Carruthers v. Jack Waite Mining Co., 14 F. R. D. 475 (S. D. N. Y.);
Steinberg v. Hardy, 90 F. Supp. 167 (Conn.);
Steinberg v. Adams, 90 F. Supp. 604;
In Re: Western Tool & Mfg. Co., 142 F. 2d 404 (C. A. 6);
Rogers v. Guaranty & Trust Co., 288 U. S. 123;
Delaware & Hudson Co. v. Albany & S. R. Co., 213 U. S. 435.

POINT II.

Section 14:9-1, *Et Seq.* as Amended and Interpreted Were Unconstitutional.

This Court and the Courts of New Jersey have held that the right to the protection of a two-thirds vote held by a minority stockholder cannot be diminished by a subsequent statute passed by the State, such legislation being prohibited by Article I, Section 10, United States Constitution which provides that no state may pass a law impairing the obligation of contracts.

See:

In re: Collins-Doan Co., 1 N. J. Super. 441, 61 A. 2d 913;

In re: Newark Library Ass'n, 64 N. J. L. 217;

Grupe v. Rudisill, 101 N. J. Eq. 145, 136 Atl. 911;

Vanden Bosch v. Michigan Trust Co., 35 F. 2d 643 (C. A. 6);

Coombes v. Getz, 285 U. S. 434;

Faunce v. Boost Co., 15 N. J. Sup. 534, 83 A. 2d 649.

The plaintiffs became stockholders subsequent to 1945 and prior to 1949. Their rights have been prejudiced, because the statute as interpreted by the Court of Appeals permits 51% of the stockholders to materially change an option plan, instead of the requirement that only 66⅔% of the stockholders could change the plan.

In addition, Section 14:9-3 (App. 2a) permits certain classes of stockholders to seek an appraisal upon the creation of an option plan. This class of stockholders is deprived of their appraisal rights, if they approved the original 1945 plan but did not desire to approve the directors plan passed in 1949.

The decision below to the effect that the 1948 amendment to the New Jersey Statute (14:9-4) (App. 3a) allows directors of a corporation to make major and radical changes in existing stock option plans can not be reconciled with the decisions of this Court in *Coombes* v. *Getz,* 285 U. S. 434, 441-442, holding that the reserve power of a State to repeal or alter laws pertaining to corporations is not unlimited and "neither

vested property rights or the obligation of contracts of third persons may be destroyed or impaired." If the amended statute had been construed by the Court below as petitioners contend it should be, then directors of a corporation could only make *minor* revisions in option plans and the constitutionality of the amended statute would not be questioned. By the decision below, the requirement of the necessity of a two-thirds vote of the stockholders to materially change or revise a plan was abolished and now the directors by resolution only could radically change a plan. As a result the stockholders were (1) deprived of their voting rights under N.J.S.A. 14:9-2 and their right to an appraisal of their stock value if they dissented, as provided in N.J.S.A. 14:9-3. Since N.J.S.A. 14:2-8 (App. 5a) provides that the New Jersey Corporation statutes become a part of the charter of every corporation, the State of New Jersey cannot impair the obligation of contract between the corporation and the stockholders contrary to Article I, Section 10, of the United States Constitution under the decision in the *Coombes* case.

The New Jersey Courts also recognize the restrictions of Article I, Section 10, of the United States Constitution in respect to the power of the State to make subsequent legislation effecting contract rights of stockholders. In *Grupe* v. *Rudisill,* 101 N. J. Eq. 145, 136 Atl. 911, the Court held that the rights of church members under the charter of the church requiring a vote of ¾ths of the members of the church for the sale of church property could not be overridden by a subsequent New Jersey Statute. To the same effect see

Faunce v. Boost Co., 15 N. J. Super. 534, 83 A. 2d 649, 652; *In Re* Collins-Doan Co., 1 N. J. Super. 441, 61 A. 2d 913, 915.

POINT III.

Both the Revised Option of 1949 and the Issuance of the Stock in 1949 Constitute a Gift of the Corporate Assets.

The sole problem in determining whether the transaction constituted a gift is whether at the time it was made the corporation was insured that it would receive any asset or whether Mr. Voit was obligated to suffer any liability or detriment.

Mr. Voit was not obligated to remain in the employ of the company subsequent to the granting of the option or after the purported exercise of the option. He was not obligated to make any payments on the stock. The corporation was not insured that it would ever receive payment for the stock or that it would receive anything for the granting of the option.

The highest Court in New Jersey has held that an option plan must be supported by some consideration.

Eliasberg v. *Standard Oil Co.*, 23 N. J. Super 431, 92 A. 2d 862.

The Courts have consistently held in New Jersey that gifts of the corporate property cannot be made to its directors without the consent of all of its stockholders.

Tooker v. National Sugar Refining Co., 80 N. J. Eq. 305, 84 Atl. 10;

Deuts, Presto, Kirche v. Presto of Elizabeth, 89, N. J. Eq. 242, 104 Atl. 642;

King Machine Co. v. Caparoso, 2 N. J. Super 230.

The principal enunciated has been approved by this Court in,

Rogers v. *Hill,* 289 U. S. 582.

Section 14:9-1 *et seq.* (prior to the 1948 amendment) was passed upon and a similar transaction was held to be a gift in,

Penn v. Robertson, 115 F. 2d 167 (C. A. 4).

The cases have unanimously held that the granting of an option without consideration constitutes a gift.

Kerbs v. California Eastern Airways, 90 A. 2d 652 (Del.);

Holthusen v. Edward G. Budd, Mfg. Co., 52 F. Supp. 125 (D. C. E. D. Penn.);

Rosenthal v. Burry Biscuit Corp., 30 Del. Ch. 299, 60 A 2d 106.

The directors could not permit Mr. Voit to use the corporate assets in order to pay for his stock.

Marcus v. Otis, 168 F. 2d 649 (C. A. 2);

Upson v. Otis, 155 F. 2d 606 (C. A. 2);

Bromschwig v. Carthage Marble & White Lime Co., 334 Mo. 319, 66 S. W. 2d 889;

Backus v. Finklestein, 23 F. 2d 357 (D. C. Minn.).

POINT IV.

The Issuance of 10,000 Shares of Stock Violated Section 14:8-9 of the New Jersey Revised Statutes and Was Therefore Illegal.

The issuance of the 10,000 shares of stock in exchange for a note upon which there was no personal liability did not comply with the requirement that stock shall be issued for "only cash or its equivalent and property including stock of another corporation * * *" (N.J.S.A. 14:8-9, App. 1a). In the instant case the corporation did not even receive a promise of future service in exchange for the issuance of its stock.

Since there was neither property or cash received by Mengel, under the New Jersey law and the law of all jurisdictions having similar statutes, the issuance of this stock was illegal.

Easton National Bank v. American Brick & Tile Co., 70 N. J. Eq. 732, 64 Atl. 917;

Holcombe v. Trenton White City Co., 80 N. J. Eq. 122, 82 Atl. 618;

Teehan v. United States, 25 F. 2d 884 (D. C. Mass);

Sohland v. Baker, 15 Del. Ch. 431, 141 Atl. 277;

Bank of Commerce v. Goolsby, 129 Ark. 416, 196 S. W. 803;

Holthusen v. Budd Mfg. Co., 52 F. Supp. 125 (D. C. E. D. Penn.).

The underlying public policy upon which this and similar statutes is predicated is that the corporation shall not issue stock without having received its value

in something other than its own stock in order to protect both the creditors of the corporation and stockholders from illegal manipulations of the management.

CONCLUSION.

For the reasons herein stated petitioners respectfully submit that this Petition for a Writ of Certiorari to the Court of Appeals for the Sixth Circuit should be granted. In the alternative, petitioners request that in the event this Petition is not granted, that this consolidated cause should be remanded to the United States Court of Appeals for the Sixth Circuit to await a final determination by the highest Court of the State of New Jersey as to the construction of N.J.S.A. 14:9-4 and related statutes.

Respectfully submitted,

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May, 1955.